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In the Supreme Court of the United States

October Term, 1959

KLAMATH [illegible], PETITIONER,

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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BRIEF FOR THE RESPONDENT IN OPPOSITION

J. Lee Rankin,
Solicitor General,

Charles K. Rice,
Assistant Attorney General,

Robert N. Anderson,
David O. Walter,
Attorneys,
Department of Justice,
Washington 25, D. C.

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In the Supreme Court of the United States

OCTOBER TERM, 1958

No. 731

KLAMATH MEDICAL SERVICE BUREAU, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 23-44) are reported at 29 T.C. 339. The opinion of the Court of Appeals (Pet. 16-26) is reported at 261 F. 2d 842.

JURISDICTION

The judgment of the Court of Appeals was entered on December 15, 1958. (R. 200.) A timely petition for rehearing was denied on January 26, 1959. (R. 201.) The petition for a writ of certiorari was filed on February 27, 1959. The juris-

diction of this Court is invoked under 28 U.S.C., Section 1254(1).

QUESTION PRESENTED

Whether amounts distributed by taxpayer to its stockholder-physicians in excess of their billings for services rendered were nondeductible distributions of corporate income, rather than compensation for personal services within the meaning of Section 23(a) of the Internal Revenue Code of 1939.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) [amended by Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—
>
> (1) *Trade or business expenses.*—
>
> (A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; • • •.
>
> • • • • •
>
> (26 U.S.C. 1952 ed., Sec. 23.)

Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939:

> SEC. 39.23(a)-6 *Compensation for personal services.* (a) There may be included among the

ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

(b) The test set forth in paragraph (a) of this section and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonsonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939, Section 29.23(a)-6, applicable for the fiscal years ending June 30, 1951 and 1952, contains substantially the same provisions as Treasury Regulations 118, Section 39.23(a)-6.

STATEMENT

The facts, as found by the Tax Court, may be summarized as follows:

Taxpayer is an Oregon corporation, organized in 1939, largely engaged in the business of selling prepaid medical, surgical, and hospital plans or contracts in Klamath County, Oregon, and providing the medical and surgical services and hospitalization required under the plans and contracts. A primary source of taxpayer's income is the premiums paid on the plans and contracts sold. Some other income is also received by taxpayer from non-contract patients using the hospital facilities owned by taxpayer. Stock ownership is limited to members of the Klamath County Medical Association. To provide the service which it contracts to supply, taxpayer entered into contracts with all members of the County Medical Association, whereby they agreed to perform the services necessary. Under these contracts, the doctors agreed to a schedule of base fees for each service which they performed and were to be paid according to a complex formula. The formula provides that when a doctor bills the Medical Service Bureau for a service he has rendered a patient, within thirty days the Bureau is to pay him fifty per cent of the base fee. Then every six months the taxpayer is to pay him (less the fifty per cent already paid) *a percentage of the base fees* billed by the doctor, determined by the ratio which the total net income of taxpayer (less certain amounts determined by the board to be necessary for corporate purposes) bears to the total fees billed by all the physicians during that six month period. During the

years in question, these payments amounted to 116.9, 115.7, and 134.3 per cent of each physician's billings for the three years, so that in each year the excess over 100 per cent represented payments in excess of the fee schedule. (Pet. 17-18.)

From 1940 to 1943, taxpayer operated solely as a service bureau and its income was solely from premiums on the contracts for medical care. However, in 1943 taxpayer bought the Hillside Hospital, and in 1946 bought the Klamath Valley Hospital and the Valley Hotel. Since that time, part of its income has come from the operation of these facilities. (Pet. 18.)

Under its subscriber contracts, services are furnished, except in emergency situations, by taxpayer's physician-stockholder-members, and hospital services by the taxpayer's hospitals. Subscribers away from Klamath in emergency cases may seek local care and taxpayer will bear the cost of the services up to the limit of the fee schedule.

There are two individual contracts with subscribers. Where family net income is less than $5,000 per year, the physician members agree "to accept K.M.S.B. Fees as full payment for Services for all eligible persons". Where family income exceeds this amount, then as to the amount charged by a physician, "Benefit payments made to the member by K.M.S.B. will act as a credit to total charges. Benefits Are the Same for All Persons Regardless of Income." There was testimony to the effect that use was not made of the clause pertaining to those earning over $5,000. (Pet. 18-19.)

Finally, all members of the taxpayer obligated themselves to resell their stock if they left the area or retired. They agreed that no member could sell his share without the written consent of taxpayer's board of directors, and within thirty days after notice to taxpayer of intention to sell, the taxpayer agreed to purchase all such stock at book value. In determining book value, the unpaid medical service charges on the part of taxpayer's member-physicians were to be valued at 100 per cent of the billings of such physicians. (Pet. 19.)

The taxpayer's fee schedule was altered and amended, generally upward, from time to time to bring it more nearly level with charges by physicians in private practice. The schedule was used for the purpose of differentiating between medical and surgical procedures, and to ensure that member physicians would receive like compensation for like services. (Pet. 19.)

The Tax Court specifically found that while the fee schedule was unreasonably low when compared to like services, procedures, and compensation charged therefor by physicians in private practice, it was equitable and fair when the lessened costs to doctors rendering services under the plan (which lessened costs are attributable to taxpayer's operation) were considered. None of the fees set were unreasonable in amount, and it was held that 100 per cent of the billings of physicians constituted reasonable compensation for the services for which taxpayer was billed. (Pet. 18.)

The Commissioner and the Tax Court disallowed the deduction of all payments made by the taxpayer to the stockholder-physicians in excess of 100 per cent of the base fees for services rendered, billed by, and approved for each of them on the ground that such excess represented distributions of the earnings of the taxpayer and not compensation to the physicians. (R. 24, Pet. 20.)

The Court of Appeals accepted the findings of fact of the Tax Court (Pet. 17-19, 25), held that it had not erroneously applied the law (Pet. 25), and accordingly affirmed its decision (Pet. 26).

ARGUMENT

The question presented here is a factual one on which the courts below agreed and there is no conflict with the decisions of this Court or other Courts of Appeals.

Whether payments by a corporation to its stockholder-employees are compensation or dividends, and whether compensation, claimed as a deduction, is reasonable in amount, are questions of fact. It has long been established that in determining these questions all circumstances must be taken into consideration, no one factor being decisive. See, for example, *Jacobs & Davies* v. *Anderson*, 228 Fed. 505 (C. A. 2d); *Becker Bros.* v. *United States*, 7 F. 2d 3, 7 (C. A. 2d); *Twin City Tile & M. Co.* v. *Commissioner*, 82 F. 2d 229, 231 (C. A. 8th); *William S. Gray & Co.* v. *United States*, 35 F. 2d 968 (C. Cls.); *Am-Plus Storage B. Co.* v. *Commissioner*, 35 F. 2d 167 (C. A. 7th); *E. Wagner & Son* v. *Commissioner*, 93 F. 2d

816 (C. A. 9th); *Doernbecher Mfg. Co.* v. *Commissioner*, 95 F. 2d 296 (C. A. 9th); *Marble & Shattuck Chair Co.* v. *Commissioner*, 39 F. 2d 393 (C. A. 6th); *Long Island Drug Co.* v. *Commissioner*, 111 F. 2d 593, 594 (C. A. 2d); *Mayson Mfg. Co.* v. *Commissioner*, 178 F. 2d 115, 119 (C. A. 6th); 4 Mertens, *Law of Federal Income Taxation* (Rev.), Sections 25.64, 25.68. The courts below followed this accepted rule in resolving the issue here.

In the present case there are circumstances, recited in the opinion of the Court of Appeals (Pet. 21-23), which, arguably, could lead to the finding that the amounts paid above 100 per cent of billings were compensation, and were reasonable. On the other hand, there are important circumstances to the contrary, also recited in the opinion. (Pet. 24.) Taking all the circumstances into consideration, and finding no one factor decisive, the courts below found that the payments above 100 per cent of billings were not deductible compensation but were distributions of earnings. By its petition, the taxpayer is here seeking a second appellate review of this factual determination.

The opinion below did not set out any new principle of law, nor is there any conflict with principles of law laid down by this Court or by other Courts of Appeals. In *Commissioner* v. *Flowers*, 326 U. S. 465, 470, this Court pointed out that the question of deductibility of expenses is usually a question of fact for the Tax Court. In *Peurifoy* v. *Commissioner*, 358 U. S. 59, it refused to intervene in the determination of a fact question. In *Lucas* v. *Ox Fibre*

Brush Co., 281 U. S. 115, the question of the reasonableness of the payments was not in issue before this Court nor is the instant decision contrary, as taxpayer asserts (Pet. 10), to the pronouncements made therein. The courts below, in line with *Botany Mills* v. *United States*, 278 U. S. 282, 288-290, and *Welch* v. *Helvering*, 290 U. S. 111, correctly held that the burden was on the taxpayer to establish its right to the deduction.

Taxpayer (Pet. 7) objects to the additional reason given by the Court of Appeals for affirming the decision of the Tax Court, namely that the payments above 100 per cent of billings were not necessary expenses (Pet. 25-26). This comment, unnecessary for the decision of the case, did not purport to set out as a general principle, divorced from the particular situation of this taxpayer, a rule that voluntary payments of additional compensation can never be an ordinary and necessary expense. Here again, the court was dealing with the facts of a single case. In the light of the history of taxpayer's activities, a conclusion that voluntary payments to the doctors above 100 per cent of their agreed-upon fee schedule were not a necessary expense was, we submit, a permissible one.

Finally, the taxpayer requests this Court to intervene in order to set forth "all the criteria to be employed in deciding the question in issue." (Pet. 9.) This request, however, merely reflects the dissatisfaction of taxpayer with the weight given by the courts below to the different factors here present, or, perhaps, a desire to have this Court say that some one

criterion is decisive. In either event, we submit that there is no showing of a conflict of principle among the Courts of Appeals, nor of difficulty in determining the appropriate criteria, such as to call for further review by this Court.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

J. LEE RANKIN,
Solicitor General.

CHARLES K. RICE,
Assistant Attorney General.

ROBERT N. ANDERSON,
DAVID O. WALTER,
Attorneys.

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